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June 12, 1996

DOCKET FILE COPY ORIGINAL

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, NW, Room 222
Washington, DC 20554

Dear Mr. Caton:

Re: *CC Docket No. 96-112, Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services*

On behalf of Pacific Bell and Nevada Bell, please find enclosed an original and six copies of their *"Reply Comments"* in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Jay Bennett

Enclosure

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services	CC Docket No. 96-112

REPLY COMMENTS OF PACIFIC BELL AND NEVADA BELL

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SUMMARY

Price cap LECs that have chosen a no sharing option have neither the incentive nor the ability to cross subsidize between regulated and nonregulated services. Competition eliminates any motivation to add unnecessary costs to regulated services; the no sharing option severs the final tenuous link between costs and rates. Commentors urging the Commission to adopt strict cost allocation rules do not factually or logically support their rhetoric about how price cap LECs would cross-subsidize. The Commission should eliminate unnecessary cost allocation requirements for price cap LECs that elect a no sharing plan.

Where cost allocation can affect regulated rates, the Commission must exercise its expertise and discretion only to further the intent of the Telecommunications Act of 1996 for a "pro-competitive, deregulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services...." Overallocating common costs to nonregulated services will eliminate LECs' incentives to deploy integrated systems and discourage the rapid delivery of advanced technologies and services.

All allocation methods are inherently arbitrary and at odds with fundamental economic pricing principles. However, allocation of common costs based on directly assigned plant is a method that will minimize the inefficiencies of arbitrary allocation. Part 64 rules direct LECs to allocate costs based on cost causation. Allocation on the basis of directly assigned plant is tied to cost causation and thus is the most consistent with Part 64 rules.

In contrast, an industry-wide fixed allocation factor would have no basis in reality. For that reason, applying a single uniform fixed factor to allocate costs of different nonregulated

services using differing technologies in different markets would be arbitrary and capricious. A 50/50 allocation is particularly unreasonable as a standard for all LECs. If, however, the Commission requires a fixed allocation factor, LECs must have the flexibility to select an allocator that is appropriate to their unique circumstances.

A new rule capping loop costs is unnecessary because price cap rules have already had the effect of capping loop costs for price cap companies.

Commentors' proposed methods for determining network costs are not sound and should not be adopted. We explain why AT&T's methodology does not reflect sound economic principles. We also explain the deficiencies of the Hatfield model which the Commission should reject.

The Commission's proposal to treat reclassified common loop plant exogenously has no support from either the price cap or Part 64 rules. The intent of price cap regulation is to increase a LEC's incentive and opportunity to develop and introduce new services, invest in new technology and upgrade its network. Treating reclassified network plant as exogenous works against those goals. Moreover, the Commission has no basis to remove investment costs that have never been included in calculating interstate service rates. And, as the Commission clearly acknowledges, cost allocation rules are not intended to provide a cross-subsidy for regulated services -- the effect of exogenous treatment of reclassified common loop plant.

Cost allocation rules are unnecessary in a competitive market. At best, rules developed here will be used for only a short time. The Commission must act in a manner that avoids cost distortions that will ultimately undermine the long term Congressional goals of developing infrastructure, encouraging competition and eliminating unnecessary regulation.

Before the
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In the Matter of Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services	CC Docket No. 96-112

REPLY COMMENTS OF PACIFIC BELL AND NEVADA BELL

I. Introduction

The Commission's decision on the cost allocation treatment of common costs will profoundly affect the kinds of new services and when they will be made available to all Americans. This NPRM is an opportunity for the Commission to promote the goals of the 1996 Telecommunications Act.[1] Alternatively, it could establish rules that are disincentives to competition and innovation to favor cable incumbents' policy.

As we said in our comments, cost allocation is unnecessary and should be eliminated for price cap LECs that have chosen a no sharing option. The cable interests insist that the strictest of cost allocation rules are required because price cap LECs have the incentive and the opportunity to cross-subsidize. Nowhere among their pages of comments, however, will the Commission find either factual or logical support for that notion. The Commission will find only rhetoric -- nothing that explains how a price cap company that elects the no sharing option can cross-subsidize nonregulated services. There is simply no mechanism that will allow cost shifts that would result in increased regulated rates. The reason is clear: In California, intrastate rates

[1] Telecommunications Act of 1996, Pub. L. No. 104-104, 101 Stat. 56 (1996) (*1996 Act*); Conference Report, S. Rep. 104-230, p. 113 (Feb. 1, 1996) (*Conference Report*).

have been *capped* since 1995. Those rates were based on 1989 costs.[2] Similarly, interstate rates are *capped* based on investment forecast through July, 1991. Investment since that time has not been and cannot be included in either intrastate or interstate price cap rates. The no sharing option severs the final tenuous link between costs and rates. The Commission should waive Part 64 for these companies.[3]

Where cost allocation can affect regulated rates, the Commission must make reasonable policy decisions and establish appropriate cost allocation rules. Reasonable judgments are those which are consistent with the policies established by Congress. The Commission must exercise its expertise and discretion only to further the goals of the Communications Act and the 1996 Act. Thus, the only reasonable policy decisions are those that "provide for a pro-competitive, deregulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans by opening all telecommunications markets to competition...."[4] The tentative conclusions in the NPRM that will overallocate costs to nonregulated services are not reasonable. They will eliminate incentives for LECs to deploy integrated systems and new advanced technologies and services. Pacific Bell intends to deploy our Advanced Communications Network because that network will benefit consumers by providing improved telephony services as well as advanced

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[2] The California Public Utilities Commission suggests that ratepayers who do not use advanced services should not be required to pay for a network capable of providing them. CPUC, p. 3. Since new investment has not been included in intrastate rates (which were based on 1989 costs), intrastate ratepayers have not paid for the network improvements made in this decade.

[3] §220(a)(2) of the Communications Act does not require the Commission to have procedures for allocating costs between services. Cox, p. 12, n.15; GSA, pp. 8-9. To the contrary, sections 401 and 706 of the 1996 Act *require* the Commission to forbear from unnecessary regulation when appropriate. Similarly, commentors that suggest that §254(k) (on universal service) requires cost allocation rules ignore the clear language of the section which directs the Commission to establish any *necessary* cost allocation rules. As we have shown above and in our earlier comments, cost allocation rules are not necessary for price cap carriers electing the no sharing plan.

[4] NPRM, p. 11, para. 22.

non-video services.[5] However, unfavorable cost allocation rules will require us to consider deploying new services very closely in light of regulation, not the marketplace. LECs considering network upgrades will have good reason to postpone or decline to make upgrades. Any additional cost burden on new products, particularly during the critical start up stage, is a powerful disincentive especially when our competitors escape similar regulatory burdens.

Cable interests have seized on the opportunity provided by the NPRM to argue for preposterous cost allocation rules that will severely disadvantage any LEC that attempts to compete in video services.[6] If the Commission adopts their proposals, cable companies will have succeeded in setting public policy that serve the Cable Companies' rather than the public's interests. They will accomplish through the Commission's rules what they could not persuade Congress to adopt. The cable monopoly will be protected.

II. The Method Most Consistent With Prior Commission Rules Is Allocation On The Basis Of Directly Assigned Plant

The Commission has a well-thought out cost allocation plan that (along with price caps) eliminates any risk that regulated services might cross-subsidize nonregulated services.[7] It is

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[5] NARUC's claim that ratepayers have "underwritten the research and development enabling the creation of a valuable backbone network which will be used in the future to provide not only phone services but also video" is unfounded. NARUC, p. 4. As NARUC points out, the broadband network provides both kinds of services. As such, any related Research and Development (R&D) costs should be treated as a joint cost. Pacific Bell's CAM (Section VI, Account 6727) clearly shows that R&D costs are appropriately identified and assigned. As a default, in case such assignment is not possible, residual R&D costs are allocated using the General Allocator as an additional safeguard that shares the common costs between regulated and nonregulated operations. (CAM Section VI, Account 6727).

[6] For example, see NCTA's Comment wherein it suggests that more than 100% allocation to video may be necessary to avoid cross-subsidization. NCTA, p. 15; Attachment 1, p. 6.

[7] *Telephone Company-Cable Television Cross-Ownership Rules*, Memorandum Opinion and Order on Reconsideration and Third Further Notice of Proposed Rulemaking ("Cross-Ownership Order"), 10 FCC Rcd 244, paras. 161, 166, 179-182 (1994); *Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier I LEC Safeguards*, 6 FCC Rcd 7571, 7577 (1991) ("Computer III Remand Order"), ("[W]e determine that our existing cost accounting safeguards and those proposed in the Notice constitute a realistic and reliable alternative to structural separation to protect against cross-subsidy..."); People of the State of California v. FCC, 39 F.3d 919, 926

perplexing why the Commission is contemplating abandoning what has worked successfully. Part 64 rules provide an established basis for cost allocation. Flexible Part 64 methods have successfully identified regulated and nonregulated costs.[8]

Pacific Bell chose directly assigned plant as an allocator because it is the most closely aligned with Part 64 cost causation methodology. As Dr. Harris points out, the inefficiencies of arbitrary allocation can be minimized by the use of directly assignable costs as an allocator.[9] Part 64 requires us to directly assign costs whenever possible; where direct assignment is not possible, common costs are allocated based on an indirect, cost causative link to other costs which have already been directly assigned or allocated.[10] Directly assigned plant is an acceptable surrogate measure tied to cost causality and thus less arbitrary than other proposed allocators. With the Commission's approval, directly assigned assets have been commonly used as a basis for allocation. Asset costs, which are predominately directly assigned, are the basis for allocating asset related costs such as depreciation.[11] Directly assigned expenses are used to allocate most joint and common costs. For example, directly assigned wages and salaries costs

(9th Cir. 1994) (price cap and strengthened cost accounting rules address concerns of cross-subsidization of enhanced services provided by RBOCs), petition for cert. filed, Nos. 94-1173 (Jan. 4, 1995) and 94-1213 (Jan. 9, 1995); United States v. Western Electric Co., Inc., 993 F.2d 1572, 1580-81 (D.C. Cir.) (information services ban lifted, in part, because of FCC price cap regulation which "reduces any BOC's ability to shift costs from unregulated to regulated activities, because the increase in costs for the regulated activity does not automatically cause an increase in the legal rate ceiling."), cert. denied, 114 S. Ct. 487 (1993).

[8] CCTA refers to audit findings by NARUC and the Commission. CCTA, pp. 8-9. We have asserted that the NARUC report was filled with misinterpretations, outright errors and broad criticisms but conspicuously lacking in specifics. Moreover, the Commission's letters referenced by CCTA concerned preliminary, not final, findings which are subject to change upon further explanation or investigation.

[9] Declaration of Robert G. Harris, Attachment I ("Harris Declaration").

[10] 47 C.F.R. §64.901 (b)(2); (b)(3)(ii).

[11] GSA asserts that any deficiencies in the depreciation reserve caused by premature retirement of facilities should be allocated as nonregulated. GSA, p. 5. The allocation of depreciation based on the related assets is cost causative due to the close relationship between plant and its associated reserves. Moreover, the identification of reserve deficiencies is associated with the regulatory policies regarding depreciation rates and effect on the price of tariffed services. Such issues are more appropriately addressed in tariff proceedings or a future proceeding on depreciation.

are used to allocate support asset investments and corporate overheads. Our approach is consistent with the Commission's well-established allocation practices.

Some commentors dismiss directly assigned plant as an allocator that would allocate "too little" cost to nonregulated services.[12] Those comments merely reflect their political goals -- it is not a reasonable basis to reject an otherwise rational and cost causative method. Moreover, the idea that a directly assigned plant allocator is "more susceptible" to manipulation is fictitious. As we discussed in our comments, the nature of equipment that is directly assigned is easily verified. If investment is not causally linked to either a regulated or a nonregulated service, it would not be directly assigned but instead treated as joint or common investment. For example, unique equipment is needed for the network to transport video services which cannot be used for telephony. Unique equipment include items such as headend electronics, video fiber optical transmitters and receivers, satellite dishes, and off-air antennas. The related costs are classified to appropriate Part 32 accounts and directly assigned to as nonregulated through the use of specific video-only accounting codes. Nor would it be in the best interest of LECs to make uneconomic decisions about directly assigned investment for the sole purpose of allocating a larger share of common costs to regulated services. Under price cap regulation, LECs are not assured of cost recovery.

MCI's disparagement of direct assignment as the basis of cost allocation is sheer nonsense.[13] Its claim that because of increased nonregulated services offered over shared

[12] Contrary to CCTA's claim, Pacific Bell never proposed to allocate 95 % of costs to telephony. CCTA continues to repeat Dr. Johnson's miscalculation of Pacific Bell's HFC network allocations that Dr. Harris exposed in our rebuttal in our §214 Application proceeding. See Opposition to CCTA's Petition to Deny, Harris Declaration, pp. 5-6, Attachment II.

[13] MCI, p. 5.

facilities, "direct assignment reflects cost causation to a much lesser degree" is a *non sequitur* -- hardly a basis for discrediting directly assigned plant as an allocator. In regard to timing issues suggested by MCI, allocation should accurately reflect the actual use of the investment. If network investment is only used to provide regulated use, all related costs are appropriately allocated only as regulated. However, if investment is later used for nonregulated services, the nonregulated service should then be allocated its appropriate share of all common costs.

Contrary to MCI's assertion, there is no need for the Commission to modify its Part 32 accounts to achieve proper classification of costs.[14] As has been well documented and accepted, the attributable cost method of cost allocation emphasizes direct assignment as a fundamental principle for cost-causative allocation of amounts between regulated and nonregulated activities.[15] Given the paramount importance that directly assigned costs play in Part 64 rules, the Commission recognized the need for the use of subaccounts and function codes to maximize direct assignments.[16] It further directed the use of sub-pools to achieve greater precision in the allocation of costs.[17] Use of such coding to subdivide costs has a long history in both Part 32 classifications and Part 64 cost allocations, and should continue to play an important role in the allocation of network plant. Each carrier has successfully adapted its own accounting codes to achieve the objectives of Part 32 and Part 64, including the direct assignment of costs. Similarly, the burden of additional subsidiary tracking requirements is unnecessary. Property record

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[14] MCI, p. 5.

[15] *Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities*, Report and Order, 2 FCC Rcd 1298, paras. 148, 162 (1987) ("Joint Cost Order"); *Implementation of Further Cost Allocation Uniformity*, Memorandum Opinion and Order, 8 FCC Rcd 4664, para. 9 (1993) ("CAM Uniformity Order").

[16] Joint Cost Order, para. 163.

[17] CAM Uniformity Order, para. 12

requirements for assets, such as those directly assigned to video services, are already clearly provided for in Part 32 rules.[18]

Cost accounting principles hold that the allocation of common costs should be logically related to cost causality to the greatest extent possible. LECs have chosen differing allocation methods. Each LEC is in the best position to select an appropriate method of cost allocation that is tailored to the individual cost characteristics of its technology, architecture, market and business plan. Each company understands the causality of its costs. While a LEC may settle on the method it believes best reflects its specific cost characteristics, the LECs acknowledge that its individual allocation methodology is only one of those which would be appropriate.

III. The Alternatives Suggested By The NPRM Are Not Appropriate

A. Requiring an industry-wide fixed allocation factor is arbitrary and capricious and lacks any rational basis.

The Commission's tentative conclusion to adopt a fixed factor to allocate common costs and the suggestion of a 50/50 allocation are entirely unreasonable.

As the Commission acknowledged, all allocation is somewhat arbitrary.[19] But allocators that have no basis in reality are arbitrary and capricious and should not be adopted. Applying a single uniform fixed factor to allocate cost of different nonregulated services using differing technologies in different markets has no rational basis. Continental Cablevision agrees:

> Critically, the proposal to use a 50/50 allocator is fundamentally flawed.... While superficially appealing, the FCC should reject this suggestion as it is *not based on any reasoned principle....*[20]

[18] 47 C.F.R. 32.2000(e) and (f).
[19] NPRM, para. 20.
[20] Continental Cablevision, Inc., pp. 6-7.

Cable interests focus on the non-traffic sensitive character of loop plant to suggest that only a fixed factor allocator would be appropriate. They are wrong. Usage is not an appropriate allocator for video services, but other cost causative measures can clearly be determined -- as shown by the variety of factors proposed by the LECs.

The Commission should not take one company's proposal as the standard for an entire industry. SNET's proposed 50/50 allocation is based on its particular technology, marketplace, business and political perspectives. A 50/50 allocation may be reasonable for a specific technology, a specific mix of customer usage and a specific geography but it is not reasonable for every other LEC.[21] SNET acknowledges it is not a valid measure for the industry.[22] As SNET's expert, Dr. Taylor testified,

> SNET's proposal to assign 50 percent of the fixed common costs to telephony and 50 percent to services ... has no foundation in cost causality. However because any allocation (i) precludes subsidization of Personal Vision [SNET's programming affiliate] services by telephony services, (ii) will not inhibit SNET's network investment, and (iii) apparently harms the competitive prospects of neither SNET or Personal Vision, the allocation is reasonable from SNET's *business* perspective.[23]

If the Commission requires a fixed allocation factor, it must allow the LEC the flexibility to select an allocator that is appropriate to its unique circumstances. Allocators must be sufficiently flexible to allow for differences in quantities and types of services, technologies and companies. A single uniform allocator will not accommodate these needs. In its well-established cost allocation methods, the Commission shunned the use of a fixed uniform allocator and for good reason -- Part 64 is predicated on cost causality which cannot possibly be

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[21] See also Harris Declaration, pp. 2, 8-9.
[22] SNET, p. 9.
[23] SNET Comments, Affidavit of Dr W. Taylor, emphasis added.

found when a single fixed factor is uniformly applied to different technologies, markets, and services. The Commission's choice of a uniform fixed factor unrelated to cost causality here will be viewed as a completely politically expedient decision,[24] with no rational foundation and inconsistent with the 1996 Act's directive to promote competition and the quick delivery of advanced telecommunications services.

Moreover, if the Commission adopts any form of common cost allocation, it should be clear that it does not intend that these cost allocations are to be used to limit LECs' pricing flexibility in offering video or other nonregulated services. The Commission has been clear that the intent of its cost allocation rules is not to establish pricing for nonregulated services: "The pricing of individual nonregulated products and services does not fall within our statutory mandate. Complaints about predatory pricing in nonregulated markets are the province of the antitrust laws.... It is not our purpose, not should it be our purpose, to seek to attribute costs to particular nonregulated activities for purposes of establishing relationship between cost and price."[25] Fundamental economic pricing principles dictate that prices should be set on the basis of both cost and demand, not arbitrary allocations.[26]

B. New rules capping loop costs are unnecessary.

Some cable commentors suggest the Commission adopt both a cap on loop costs and a fixed allocation factor. In addition to our comments as to why a ceiling on loop costs are not appropriate, a new rule to cap loop investment is unnecessary because price cap rules have

[24] Cox also recognized that a "fixed allocator recognizes that cost allocation is a policy decision...", Cox, p. 8.
[25] Joint Cost Order, para. 40.
[26] Harris Declaration, pp. 4-6, 7-8.

already in effect capped loop costs for price cap companies.[27] Only investment forecast through July, 1991 is included in interstate price cap rates. Since then, all network upgrade costs have been treated endogenously.

C. New methods proposed by commentors are unsound and should not be adopted.

AT&T's proposal for allocation of shared costs does not reflect any economic principle known to us. As might be suspected, because AT&T is the major purchaser of LEC telephony services, its proposed method unfairly overallocates costs to the LEC's non-telephony services. We explain why the methodology proposed by AT&T is not sound economic theory in the declaration of Mr. R. Scholl. (Attachment III).

AT&T and MCI also suggest that the Hatfield model could be used to determine network costs.[28] The Hatfield model cannot be accurately described as a "TSLRIC model". AT&T made the same proposal in the Interconnection docket.[29] We repeat our recommendation that the Commission reject the Hatfield model.[30] The Hatfield model will not properly determine costs of the network. We will not reiterate our reasons here, but we have attached a copy of Mr. Scholl's earlier declaration in Docket 96-98 on the deficiencies of the Hatfield model. (Attachment IV).

Cable commentors also suggest that there is no need to improve the network; that improvements only add unnecessary cost; and that the broadband network is only for the purpose

[27] We discussed the disadvantages of capping loop costs in our comments. Pacific Bell and Nevada Bell Comments, p. 12. Cable interests also reject a ceiling on loop costs. NCTA, p. 5; Time Warner, p. 7; Cox, pp. 7-8.
[28] AT&T, p. 5, fn.8; MCI, p. 7.
[29] Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, ("Interconnection Docket"), AT&T Comments, p. 51.
[30] MCI also suggests stand alone cost estimates could be obtained from a 1990 study by Johnson and Reed. MCI, p. 8. In our video dialtone proceeding, Dr. Harris explained why the Reed study would not be appropriate to determine Pacific Bell's deployment costs. See Attachment II, pp. 4-6.

of providing nonregulated video services.[31] NARUC suggests that the Commission is required by law to convene a joint board to decide regulated or nonregulated cost allocation.[32] None of these positions is accurate. First, even without video services, a broadband network benefits regulated telephony consumers because the telephony network will be more reliable, provide improved quality, and require less maintenance. The new network that provides telephony services will also have the capacity to provide advanced services. Moreover, the 1996 Act has settled the debate about whether or not technological improvements are warranted by directing the Commission to "provide for a ... policy framework designed to accelerate rapidly ... deployment of advanced telecommunications and information technologies and services...."[33] Second, NARUC's reliance on Section 410(c) is misplaced. This rulemaking will not impact separations *procedures*. This rulemaking is to change Part 64 rules, not Part 36 rules. The Part 64 rule changes may impact amounts that would then be subject to Part 36 but there is no statutory requirement for the Commission to refer changes in amounts to be separated to the Joint Board.

Finally, while we believe that regulation of competitive services makes no sense, if onerous cost allocation rules are necessary to protect consumers when telephone companies provide video services, the Commission should apply similar allocation rules to cable interests upon their entry into telephony markets. It has not done so. We believe Bell South's suggestion, however, is far better -- the Commission should apply the rules applicable to "price cap" cable operators [which] are more appropriate for both cable operators and price cap telephone

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[31] CCTA, p. 18; Scripps Howard, p. 4; Continental Cablevision, p.3; Time Warner, p. 11.
[32] NARUC, p. 4.
[33] Conference Report, p. 113.

companies than are the telephone rules.[34] Fair public policy cannot justify a position that permits cable monopolies to enter the telephone business but permits them to escape onerous regulations that apply to others. Contrary to Time Warner's self serving assertions,[35] there is no policy difference that should cause unequal application of normal cost accounting rules. Asymmetrical regulation will create a competitive imbalance which will unfairly handicap LECs and undercut the implementation of competition and infrastructure improvement.

The thrust of our competitors' comments is obvious. If treated as credible, these commentors will succeed in imposing their own policy goals to the detriment of competition and technical innovation.

IV. There Is No Basis In Law Or Fact To Treat Reclassified Loop Plant Exogenously

Neither the price cap rules nor Part 64 support the exogenous treatment of reclassified common loop plant. That proposal stands the price cap policies and goals on their ear. The Commission designed price cap regulation with the belief "...that under price caps the LECs will have increased incentive and opportunity to develop and introduce new services; to invest in new technology, like ISDN and SS7 that will promote cost savings and efficiencies; to innovate; and to upgrade their networks."[36] We have met those goals. In the past five years, we have reduced Pacific Bell's interstate price cap indices by over $250M. Each year, we've decreased Pacific Bell's access rates by more than 5% even though our initial price cap rates were far below

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[34] Cost allocation and affiliate transaction rules for cable industry apply only to "cable operators who either elect cost of service regulation or seek to adjust benchmark/price cap rates for affiliated programming costs." Rate of return and a uniform system of accounts are not applied to cable operators that elect benchmark regulation even though they might later elect to convert to cost of service regulation. BellSouth, pp. 5-7.

[35] Time Warner, p. 9, fn. 8.

[36] *Policy and Rules Concerning Rates for Dominant Carriers,* Second Report and Order, 5 FCC Rcd 6786, para. 335 (1990).

the national average. The price cap rules intend that LECs benefit from their efficiencies. Consumers are to benefit from efficiencies, too. They will have improved quality and greater choice -- especially among new services. Now, as we prepare to begin to offer consumers the benefits intended by the Commission, the ground rules are threatened. Without sound basis, the Commission tentatively concludes that companies that make their networks more efficient and productive should be penalized if those improvements are used for any nonregulated service.

Moreover, there is no rational basis to treat reclassification of common loop plant costs as exogenous. Pacific Bell's embedded plant (upon which price cap rates were based) is not being used for video because it is not suitable for broadband services. Investment in new loop plant to be shared by regulated and nonregulated services has not been included in price caps -- so it is not "in" our rates. No logic would justify removing costs from our rates that have never been included. Doing so will deprive investors of a reasonable return on their investment and would be confiscatory. Requiring exogenous treatment for changes in usage of investment would also be bad policy. It would be a disincentive to improving the network and providing new services. Discouraging innovation is directly contrary to the Commission's professed goals of bringing advanced technology and services to the American public. Finally, as we explained in our comments, the reclassification of plant does not satisfy the elements required by the Commission for exogenous treatment under price cap regulation.[37]

Nor does Part 64 provide any basis for exogenous treatment of reclassified plant. The effect of the proposed exogenous treatment would be to have nonregulated activities cross-subsidize regulated activities. The Commission specifically disclaimed that as an intended

[37] Pacific Bell and Nevada Bell Comments, p. 16.

outcome of Part 64: "We are seeking to promote an equitable sharing of common costs; but we would not think it proper to attempt through cost allocation rules to arrange a subsidy for regulated activities."[38] The Commission should not adopt exogenous treatment.

V. Conclusion

The Commission should focus on long term Congressional goals: promoting infrastructure development, encouraging competition and eliminating unnecessary regulation. There is little debate that cost allocation rules will be unnecessary with effective competition. Competition in telephony services eliminates any incentive for telephony services to absorb costs that should be attributed to other services. Regulators promise continued diligence in opening telecommunications markets to competition, especially in local exchange services. Thus, the cost allocation rules under consideration are only transitional and those policies should not take precedence over longer term Congressional goals. The Commission would be more productive if it focused on policies that further long term goals of infrastructure development, competition and deregulation and not on rules that reinstate rate of return regulation which the Commission has replaced for price cap companies. Advanced telecommunications and information technologies and services will not be made quickly available to all Americans if the Commission adopts rules that cause an unreasonable allocation of common costs. Inflexible rules will eliminate LEC incentives to compete or to improve networks to permit advanced telecommunications services. We agree with MCI, "Competition will only be effective to the extent that competitors have an opportunity to compete on their ability to provide efficient, high quality video services. It cannot

[38] Joint Cost Order, para. 109.

work if regulation introduces distortions in one competitor's underlying costs...."[39] If cost allocation rules continue to apply, the Commission must assure that its decisions promote competition. A system that subsidizes any one participant in the competitive market distorts the market for all.[40] That is exactly what onerous cost allocation requirements for nonregulated services will do. Regulatory-caused distortions are contrary to Congress' intent to promote competition (in video markets), to encourage investment in new technologies and to maximize consumer choice of services that best meet their information and entertainment needs.[41]

Respectfully submitted,

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Date: June 12, 1996

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[39] MCI, p. 13.
[40] Alabama PUC, p. 8.
[41] Conference Report, 172.

Attachment I

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Allocation of Costs Associated	)	CC Docket No.96-112
with Local Exchange Carrier Provision	)	
of Video Programming Services	)	
	)	

DECLARATION OF ROBERT G. HARRIS

I, Robert G. Harris, declare the following:

A. Qualifications and Summary of Testimony

1. My name is Robert G. Harris. I am an Associate Professor in the Walter A. Haas School of Business, University of California, Berkeley. I earned Bachelor of Arts and Master of Arts degrees in Social Science from Michigan State University and Master of Arts and Doctor of Philosophy degrees in Economics from the University of California, Berkeley. At Berkeley, I teach undergraduate, MBA and PhD courses in Business & Public Policy and Telecommunications Economics. My academic research has analyzed the effects of economic regulation and antitrust policies on economic performance, and the implications of changing technologies and economics for public policies, especially in telecommunications and transportation. While on leave from the University in 1980-81, I served as a Deputy Director for Cost, Economic and Financial Analysis of the Bureau of Accounts at the Interstate Commerce Commission. I have served as a consultant to the United States Department of Transportation, the United States General Accounting Office, the United States Office of Technology Assessment, the United States Department of Justice, the California Attorney

General and the California Department of Consumer Affairs. I have also been a consultant to telecommunications and transportation companies regarding product pricing, new product development, regulatory policy and competitive strategy.

2. I have testified before the United States Senate, the United States House of Representatives and the Joint Economic Committee of Congress on telecommunications, antitrust and transportation policy issues. I have testified on spectrum auction and licensing policies, telephone rate design, costing and pricing principles, alternative (price caps) regulation, competition policy and/or interconnection policies before the Federal Communications Commission, the Canadian Radio-Television and Telecommunications Commission, the Subsecretariat of Communications of Mexico and the public utility commissions of California, Colorado, Indiana, Illinois, Iowa, Kansas, Michigan, Nevada, Ohio, Oregon, Pennsylvania, Tennessee, Utah, Washington and Wisconsin.

3. In this declaration, I will comment on the Commission's proposal to allocate the common costs of loop plant equally between regulated and nonregulated activities and reply to the direct comments of several other parties. My basic positions are these:

- there is no valid economic or public policy rationale for requiring the allocation of common costs between regulated and unregulated services of pure price cap regulated carriers, such as Pacific Bell, which has neither the incentive nor the ability to cross-subsidize from basic ratepayers to competitive services;

- while any rule for allocating common costs is arbitrary, the proposed uniform fixed factor allocation of 50% is especially problematic because it ignores the significant differences in network architectures and associated cost structures of the technologies being deployed for video and telephony services;

- a uniform fixed factor allocation rule would reduce economic incentives for investment by local exchange carriers (LECs) in hybrid broadband networks, thereby diminishing the prospect of direct wireline competition to cable TV companies in the delivery of video programming services;

- imposing a uniform fixed factor for allocating common costs would put LECs at a serious competitive disadvantage relative to their competitors, including cable companies and new entrants into local exchange services, none of which is required to allocate common costs;

- if the Commission decides it must require the allocation of common costs between regulated and unregulated services, it should allow each company to choose a suitable method, given its economic circumstances and technology choices;
- as proposed by Pacific Bell, the allocation of common costs in proportion to directly assigned costs does least offense to economic pricing principles and should be approved as one method of cost allocation allowed by the Commission.

In addressing these issues, I urge the Commission to make choices that will promote efficient competition in the marketplace and ignore the pleas of those who so blatantly seek to use the regulatory process to restrain competition by hamstringing competitors. The nation's interest in consumer choice of a wide range of affordable, high quality telecommunications services depends on it.

B. Common Costs, Pricing and Cross-Subsidization

4. In the cases of pure price cap regulated carriers such as Pacific Bell, there is no valid economic or public policy rationale for requiring the allocation of common costs between regulated and unregulated services. Such allocations are inherently arbitrary and are at odds with fundamental economic pricing principles, which dictate that prices should be set on the basis of both cost and demand.

> "The key point is that costs do not tell the manager what price to charge. Rather, costs provide a good starting point and some important insights regarding feasible ranges for setting price.... The ultimate pricing decision depends, further, on a detailed analysis of demand and competitive reaction."[1]

> "Because cost-based approaches require that fixed costs be allocated to units of a product, there is an arbitrariness to this type of pricing.... No matter how unseemingly logical or equitable the allocation scheme, the process of allocating these costs is likely to distort the

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1 Michael H. Morris and Gene Morris, Market-Oriented Pricing: Strategies for Management. New York: Quorum Books, 1990, p. 97.

picture management has of a particular product or service."[2]

> "The determination of the contribution each product or service should make to the recovery of indirect period costs and common period costs is a managerial decision and should not be determined by an inflexible and arbitrary allocation rule." Considering the realities of the marketplace when determining prices, "...is clearly an advantage, since the important sources of profitability are external to the organization, and considering only the internal need to recover costs often leads to poor pricing decisions."[3]

This principle of pricing is especially important in multiple-use systems, when the price elasticities of different services vary substantially and cross-price elasticities among services are significant. Moreover, a company, not the Commission, is in the best position to assess market conditions and prices to maximize the contribution of services to common costs. Because markets for communications and information services are highly dynamic, with rapidly shifting customer demands and competitive conditions, pricing should be done by those closest to customers, with the best, most timely information about competing services and relative customer value. It should also be noted that, under price regulation, a company has strong economic incentives to mark up prices of competitive services above the established price floor to maximize their contribution to common costs.

5. It is now well established in the economic literature that the price floor for any given service or group of closely related services should be the long-run incremental cost of that (those) service(s).[4] Using LRIC as a price floor ensures that all customers will pay prices that

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[2] Id, p. 93.

[3] Kent B. Monroe, Pricing: Making Profitable Decisions. 2nd ed. New York: McGraw-Hill Publishing Company, 1990, p. 150-151.

[4] See, for example, the following:

Baumol, William J., and J. Gregory Sidak. Toward Competition in Local Telephony. Cambridge Mass: The MIT Press, 1993; page 61-92.

Baumol, William J., John C. Panzar and Robert D. Willig. Contestable Markets and the Theory of Industry Structure. New York: Harcourt Brace Jovanovich, 1988; pages 504-508.